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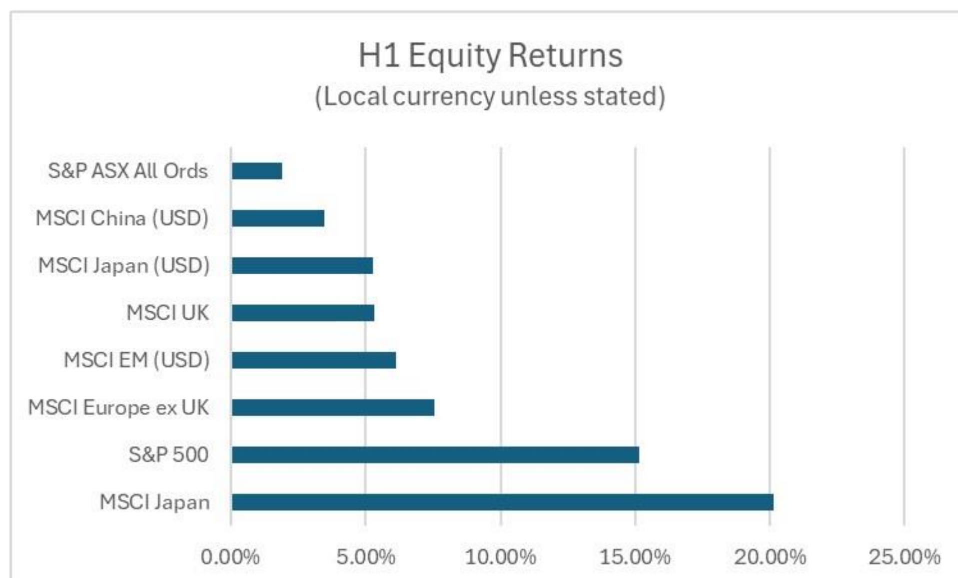
Editorial

Welcome to the 567th edition of Firstlinks.

As we are somehow already past the halfway point of 2024, it's a natural time to take stock of what's happened so far.

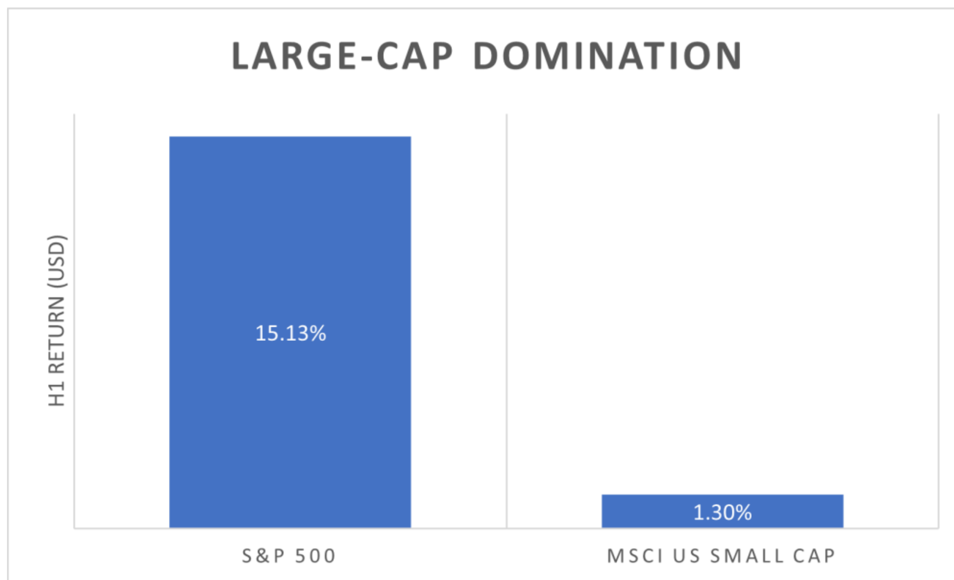
Except for Australia, it's fair to say that most of the major equity markets have started well:



The return of Japanese equities in H1 falls from over 20% to around 5% once you adjust for the weak yen by using a US dollar return.

This brings Japan in line with most of the other major developed markets and leaves a familiar outlier: the US. More specifically, it leaves us with the continued outperformance of US large-caps.

Here is the performance of the S&P 500 index of large-caps versus the MSCI US Small Cap Index in the first half:



I'm not going to comment on whether the dominance of the US market and its biggest stocks can continue. If the past 18 months have taught us anything, it's that making that kind of call – let alone profiting from it – is a fool's errand.

At the start of 2023, most commentators were expecting a US recession. Some argued this would be bad for US stocks. Others argued it would be good because it could lead to an earlier peak in interest rates.

Either way, most people agreed that there would be a recession. What actually happened? US GDP grew 2.5%. The Fed hiked four more times. The S&P 500 rose 24% regardless.

The other big macro call at the start of 2023 was that China would reopen. This proved correct. A lot of investors assumed this would cause a rally in Chinese shares. This proved to be dead wrong. China shares didn't rally. Instead, the MSCI China index fell by 13% in US dollar terms.

2024's biggest macro prediction is also off to a terrible start.

By the end of December 2023, CME Group's Fedwatch tool estimated 70% market confidence that the Fed would cut by at least 100 bps over the next twelve months. That, so the theory went, could be good for stocks.

As of July 2, the Fed has delivered exactly zero basis points in cuts. That would be bad for stocks, right? Apparently not. The S&P 500 Index is up 15% in six months and Nvidia is up another 150%.

This is why trying to profit from macro calls or predicting some economic event usually fails. You don't just need to be right about the event. You also need to be right about how markets will react.

With that in mind, there's something to be said for concentrating on what you can control. This is something the writer of today's lead article has taken to heart in her investment approach.

Shani Jayamanne's job title at Morningstar features the words *Investment Specialist*. She is passionate about investing and doubly passionate about teaching the benefits of strategically sound investing to others. Yet when it comes to her own investments, Shani takes a deliberately uninterested approach.

If history is a guide, it's hard to bet against that paying off. See why caring a little less about your investments (but not about your investing) could be the most profitable top-down call you can make.

James Gruber

Also in this edition of Firstlinks...

Listed infrastructure valuations are lagging even though earnings forecasts are up and private buyers continue to covet quality assets in the sector. **First Sentier Investors** recently sent two of their Global Listed Infrastructure team to the US to assess the outlook. Their findings could have big implications for stocks in a traditionally low-growth sector.

Holding unlisted assets like property and private companies in your SMSF attracts extra attention from the ATO. It also brings responsibilities that, if not met, could lead to a fine or your SMSF losing its complying status. This primer from **Julie Steed** reviews valuation rules for SMSFs and what they mean for trustees in practice.

Big super funds and other institutions have piled into private credit over the past decade, helping the asset class grow from peanuts to $3.5 trillion in 2023. Despite solid returns from private credit over the past decade, retail and SMSF investors have mostly stayed on the sidelines. **Peter Szekely** from Tanarra Credit Partners makes a case that individuals should consider following the lead of big investors.

You'll often hear financial commentators comparing today's US tech stock rally to the late days of the dot-com boom. But are Nvidia and co really partying like it's 1999? **Que Nguyen** from Research Associates thinks we're far closer to being in 1996. If she's right, that means the AI investment boom could run a lot further yet. Investors can still position themselves to benefit over the long-term, even if – like usual – the boom results in widespread capital destruction.

Our next contender isn't an article, but a **survey** from the Firstlinks team. We'd love to hear your thoughts on our content and how we can make it better for you. If you'd like to help us out in a just a couple of minutes, please go here to share your thoughts.

A new report from **Michael Woods** and **Nicole Sutton** of the University of Technology Sydney claims that over 60% of aged care providers are failing to give residents the level of care they need or are entitled to. The crisis is especially acute in direct care, despite millions of dollars in extra tax funding and several providers running at a surplus. Go here to see the report's key findings.

This week's white paper comes from the **Franklin Templeton Institute** on where investors should look for earnings based on value versus projected earnings.

Curated by Jospeh Taylor and Leisa Bell

My disinterest in investments as an investment specialist

Shani Jayamanne

When we write our pieces, we have a reasonable idea of how popular they will be. The list of the most popular articles on Morningstar.com.au is predictably filled with pieces on shares. Given our audience, this makes a lot of sense.

We have self-directed investors that are largely invested in equities – and are hobbyists. We are an equity research house, and our readers enjoy the 'art' of investing. We enjoy providing in-depth analysis on companies. They enjoy picking the winners and investing towards their financial goals.

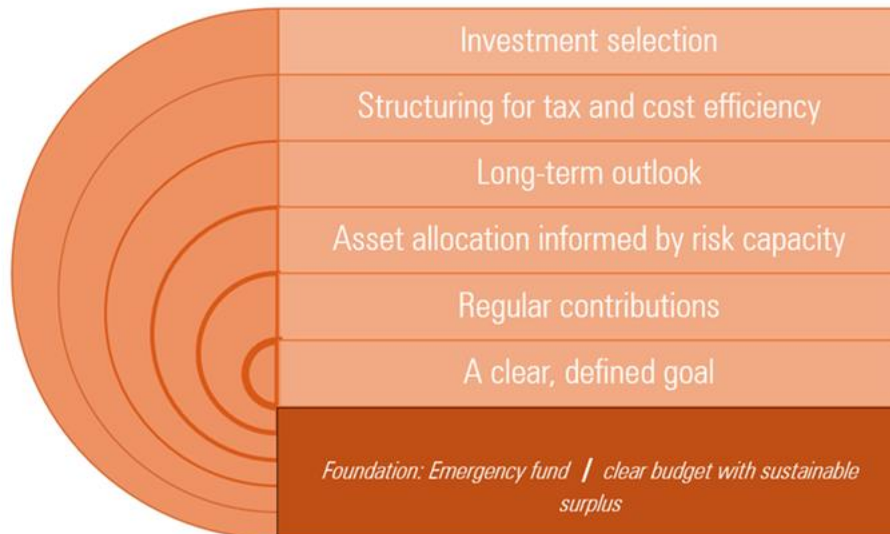
Most of these investors are looking to make well-informed and thoughtful decisions about investments that will impact whether their achieve their financial goals -whether that be a comfortable retirement, paying for education, purchasing a home, or travel. Investment selection is important.

I'm not here to try and change the perspectives of that camp. I'm here to provide the perspective that successful investing does not mean constantly searching for new investment opportunities.

The foundation of that widely held belief is that at any particular moment there are investments that are good and will outperform in the immediate future, and ones that are bad that will underperform. This view is reinforced and encouraged by professional investors who are selling investments and their ability to navigate markets to find opportunities.

I've come to an approach that flips this conventional wisdom around.

Selecting individual investments for my portfolio is not my primary concern and is the final step in my process. Other concerns, like having a well-defined budget and clear investing goals, come first and lay the foundations for everything else. Hence why they are shown at the bottom of this diagram showing my approach:



I arrived at this approach for technical and circumstantial reasons.

Let's start with the technical. In 1986, Brinson, Hood, and Beebower's seminal paper 'Determinants of Portfolio Performance' attributed 93.6% of investment performance to asset allocation. The paper focused not on the return level, but on the variation of returns. A 1991 update to the paper concludes that active decisions on investment selection by pension plans (which were used as a basis for the study) made little improvement to performance over a 10-year period. The paper championed a focus on strategic asset allocation over the long-term to increase the chances of reaching successful outcomes.

There were several adaptations of this research by other academics, including Ibbotson and Kaplan's report in 2000 – 'Does Asset Allocation Explain 40, 90 or 100 Percent of Performance?'. Ibbotson and Kaplan focused on the key question for investors – what percentage of the actual return comes from the asset allocation decisions that they make? Ibbotson explains the results in a CFA Institute paper from 2010:

> *"Asset allocation policy gives us the passive return (beta return), and the remainder of the return is the active return (alpha or excess return). The alpha sums to zero across all portfolios (before costs) because on average, managers do not beat the market. In aggregate, the gross active return is zero. Therefore, on average, the passive asset allocation policy determines 100 percent of the return before costs and somewhat more than 100 percent of the return after costs. The 100 percent answer pertains to the all-inclusive market portfolio and is a mathematical identity—at the aggregate level."*

Ibbotson's point is that because most investors can't put together a portfolio of individual investments that beat the index, the only driver of returns is the asset allocation of their overall portfolios.

The second guiding principle to my investing strategy is a focus on factors in my control as I try to build wealth and achieve my goals. That is my savings. It is minimising taxes and fees and limiting the impact of poor decisions on my investment approach.

I have rigid savings goals that are governed by my Investment Policy Statement (IPS). I try to consider these as non-negotiable fixed costs.

I have not read any academic papers on the importance of saving. I don't think any academic is going to get accolades for pointing out the revolutionary idea that capital is important to build wealth. The math isn't difficult. If I contribute $1,000 a month and am able to contribute $100 extra, it is the equivalent of a 10% monthly return. Of course, there is an opportunity cost attached to extra contributions – you don't get to spend the extra money. You don't have this same cost with investment returns. I'll touch on my experiences with savings and how it has formed such an integral part of my perception of successful investing further down.

Academic arguments are interesting but they often ignore the realities of life. Nassim Taleb writes about this in his book 'Skin in the Game'. He speaks about 'skin in the game' being contact with the real world that informs your decision making. Taleb explains 'The knowledge we get by tinkering, via trial and error, experience and the workings of time…is vastly superior to that obtained through reasoning.'

He refers to *Pathemata mathemata* - a Greek concept that describes how the abrasions on your skin guide your learning. Investing has not drawn blood (yet), but I strongly believe that your circumstances, temperament and experiences guide the type of investor you are and the investing strategy that will maximise your outcomes.

Different investment priorities in practice

There are two types of investors that prioritise security selection. There are investors, and there are speculators. New investors tend to go straight into selecting investments because strong returns from an asset class (maybe even one asset in particular) was their reason for entering the market. We saw this with the influx of new investors in 2020 and 2021.

These investors rode the wave of Covid market returns and gained premature confidence in their investment selection capabilities. It was a momentum fuelled rally and buying shares which had done well paid off. A large cohort of these entrants I would classify as speculators making tactical allocations based on recent performance.

This was a perfect example of riding the asset class wave and mistakenly attributing it to the prowess of the individual. Since then, there has been volatility but markets continue to climb and reach new highs. A contraction, and therefore a reality check, is inevitable. We've historically had a bear market every 3.5 years – it is folly to think that we will continue to avoid one going forward.

This situation is avoidable when building a portfolio from the foundations up.

Anchoring your investments to a goal means that you will have an intimate understanding of the purpose of each security in your portfolio. It will be part of an allocation to an asset class that is connected to the returns required to reach that financial goal. It will prevent poor behaviour by selling at inopportune moments to try to time the market, or because holding an investment you have surface level faith in drops which makes you nervous.

What's also worth mentioning about bear markets is that tactical allocation of funds can severely rig the game against you. Over the last 30 years, if you missed the S&P 500's 10 best days, your return would be cut in half. If you missed the best 30 days over the last 30 years, your return would be 83% lower.

This is why timing the market is an issue, but also why an overreliance of tactical asset allocation in your investment strategy can also be an issue. Not being invested in the right securities means missing most of those days. 78% of the best days occurred in a bear market. I don't want to miss out. I am perfectly content capturing the average return of the market.

Just as bull markets drive new investors, bear markets cause people to give up. Those that don't quit may find their way to adopting a strategy that focuses more on what they are trying to achieve, rather than the vehicles to get there.

I know this because I used to be one of these investors who focused more on investments than investing. When I first started investing, I purchased funds that had sex appeal with terms such as 'pure alpha', 'long-short' and 'innovation' in the name. I was extremely lucky that I invested during a very long bull run and didn't get badly burnt.

The good times kept rolling as equity markets continued to trounce other asset classes. As my career progressed, I felt an obligation to start making direct equity investments to 'justify' my work. I didn't get burnt, but I was sitting in a stockpot that was slowly coming to a rolling boil.

I started understanding myself better as an investor through these holdings. I learned two main things:

- I get incredibly nervous with direct equity holdings
- I tend to spend a lot of time over-analysing my decision and seeking information to confirm I made the right decision

How bloody exhausting. This is where I realised that a large part of investing is understanding what works for you, and deeply understanding yourself as an investor. Investing was a means to an end for me and not a journey I would actively enjoy along the way.

Fast forward to today. My portfolio outside of superannuation consists of cash and collective investment vehicles – managed funds and ETFs. The investment vehicles are concentrated mainly in equities. My cash portion is held in my emergency fund.

I no longer feel the need to continually justify my investment decisions at every turn of the market. My portfolio is connected to the foundations of the pyramid – to my goals. I have a strong understanding of why I hold each position and why it behaves the way it does through different market conditions. This understanding and the connection to my goals means that I am not tempted by each new opportunity. I have a long-time horizon for my capital to grow and compound. I've evolved my perception of investing from maximising wealth to building a model that works best to maximise my outcomes.

This has had a flow on effect of other benefits. I am more tax efficient. I limit selling and that lowers my transaction costs (as well as tax). I am cost conscious. I stay invested for the long-term. I think about how to structure my investments, so they are in the most tax efficient vehicle. These benefits are hugely important when considering total return outcomes. I've calculated the actual total return of investments in this piece. It shows the individual impact of return influencers.

I prioritise savings. This is a hard lesson to learn without experience, but I was fortunate to work early in my career at a fund manager where I could see the history of individual accounts. This drove home the importance of contributions and compounding to building wealth.

I worked in Client Services and with transaction histories and account balances all day. It was basically a view of the blueprint to building wealth – I saw how individual investors had built up their portfolios over time. Going into this job, I believed that investing was for the wealthy and had no exposure to it growing up.

Working in this role allowed me to see every type of scenario imaginable played out – including those that were contributing small amounts per week over a long time period. I have not had any lump sum wind fall and I do not expect anything in the future. I know that for me to build a comfortable life, I need to prioritise saving to build my capital base. This approach resonated with me on a graduate salary, and it kickstarted my journey with investing.

Selecting investments brings a lot of people joy. I am much more focused on investing regularly in the right asset allocation and committing over the long-term. I believe that will provide more of a difference to my outcome than choosing between two stocks.

Now, after reading this – you may ask, well, for someone that has such a hands-off approach, why on earth would you decide to make your whole career about investments?

The answer to that is – I didn't. During that story where I had that 'a-ha!' moment at the fund manager, I asked myself 'why doesn't everyone invest?'. The answer is that some people don't know this is the way to build wealth.

A lot of those people that could drastically improve their outcomes for themselves and future generations have not been exposed to their version of the 'blueprint'. It is fulfilling to be able to make this information accessible to everyday Australians and all types of investors.

My investment philosophy is individual to me. It has evolved over time and I imagine it will continue to. That is the beauty of investing. It is being able to take on other perspectives – many of which I am lucky to have shared with me by readers and listeners of the podcast. It is understanding what works for you and understanding that all of this is really just a journey to create a better life for yourself and your loved ones.

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US trip reveals inflection point for $6 billion global industry

Jessica Jouning, Sophie Smith

Valuations in listed infrastructure haven't yet responded to higher earnings forecasts or the influx of private suitors for high quality assets in the sector. Seeking answers, portfolio manager Jessica Jouning and analyst Sophie Smith from First Sentier Investors' global listed infrastructure team hit the road.

In a recent research trip to the US, Jouning and Smith touched ground in eight different states and met fifty infrastructure management teams, regulators and customers from the utility, railroad, waste management,

energy midstream and data center sectors. One of the team's biggest takeaways was that utilities are at a significant turning point on the demand front.

Demand for electricity has inflected up

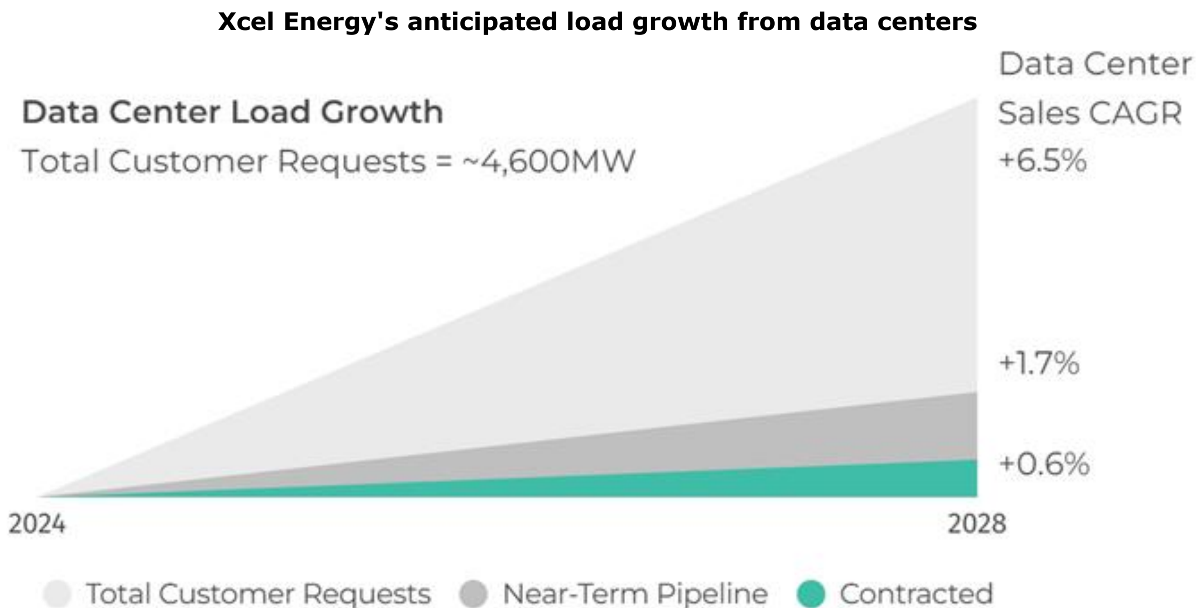
After decades of flat electricity demand for US utilities, the industry is now seeing unprecedented demand as growth in data centers and artificial intelligence (AI), electrification, onshoring and electric vehicles outweighs energy efficiency gains. One utility executive stated: "Seeing all these customers wanting 24/7 load and willing to pay for it – it is every utility's dream".

Demand is expected to accelerate as the AI rollout continues. Employees we met at a data center in Atlanta, Georgia, one of the five epicentres of the current data center boom, highlighted that the pace of leasing demand growth is "astounding".

All capacity currently under construction (425 megawatts / MW) is already sold out to 2027. In terms of how AI is boosting that demand, they said: "An average customer wants power density of 14-17 kilowatt-hours (kWh3). An AI customer now wants 70 kWh". Effectively, a five-fold increase.

As data centers (and especially AI-focused data centers) expand their footprint throughout the US, upward pressure on utility load forecasts will continue, owing to the amount of power required for processing and cooling. The following chart from Minneapolis-based electric utility Xcel Energy highlights the extent of this load growth.

Xcel Energy's anticipated load growth from data centers



Source: Xcel Energy. Data as of 19 May 2024.

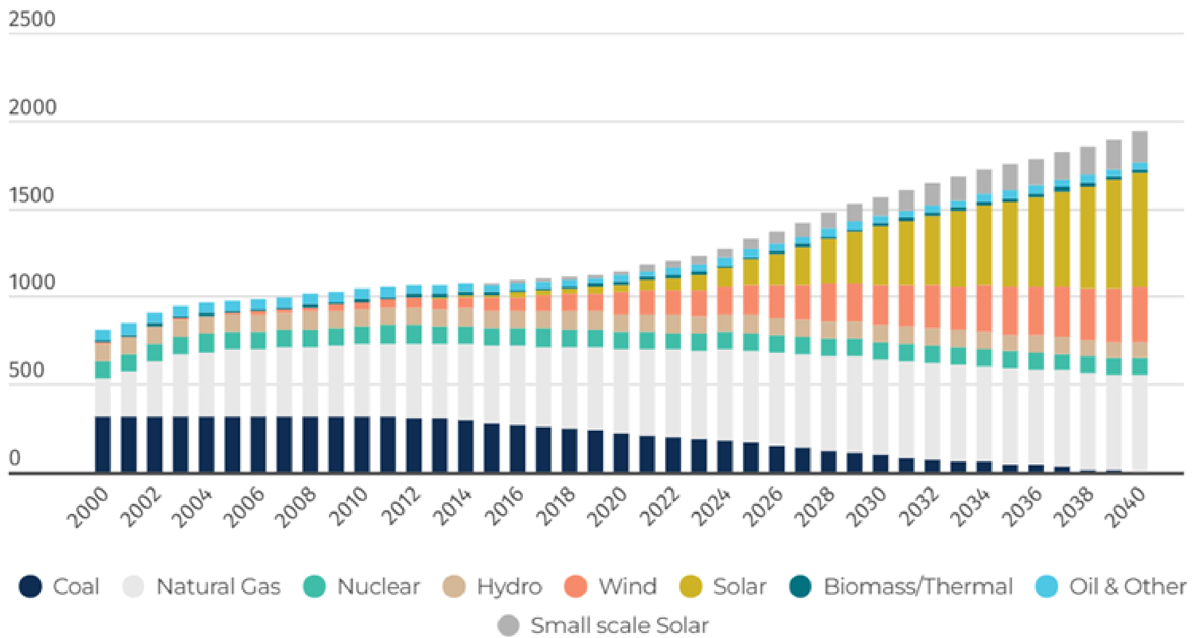
Data centers account for 4% of total US electric load today. Forecasts expect that to increase by 80-120%, to eventually make up between 6% and 10% of total US electric load by 2030 - with risk to the upside.

As this load demand increases, data center priorities have changed. An executive said: "Data centers used to ask for 24/7 power, clean energy and low prices …now they are just asking for 24/7 power".

A consistent message among utilities at our attendance of the American Gas Association conference in California was that natural gas will continue to play an important role as more renewables come online, coal plants retire and competition for energy intensifies in the face of increased load.

Natural gas represents a reliable source of backup power, especially with increased extreme weather events leading to power outages. It can also play a crucial role in meeting power needs during periods of peak demand.

US electricity generation capacity (GWs)



Source: First Sentier Investors. Data as of 31 May 2024.

Upside risk to current forecasts

As noted earlier, load growth is putting upward pressure on utility load forecasts. This is being reflected in turn in the Integrated Resource Plans (IRPs) being filed by utilities.

In 2022, Georgia Power, a subsidiary of listed electric utility Southern Company, filed an IRP with forecast load growth of less than 400 MW between 2024 and 2031. In their 2023 IRP filing, the forecast load growth for the same period was 6,600 MW (a 17 times greater increase).

These increases then flow through to utilities' investment plans, ultimately expanding the regulated asset base upon which each utility is allowed to earn a return.

For example, Pennsylvania-based PPL Corp estimated that every new large data center requesting 1 GW of power would require transmission grid upgrades costing at least US$50-150 million. For PPL, every US$125 million spent in this way equates to an additional 1% of EPS. And the growth isn't all being driven by new-build data centers.

Southern Company's CFO stated on the company's Q1 2024 earnings call that energy sales to data centers increased by 12% compared to the prior year; three quarters of this increase came from existing data centers. As today's conversations with potential data center customers progress through to tomorrow's signed deals and construction commencements, utilities will see their rate base and earnings growth profiles trend upwards.

We believe that over the next 12 months we will see material uplifts to existing IRPs because of this. First Sentier Investor's listed infrastructure portfolios are well positioned to benefit, with exposure to electric utilities including NextEra Energy, Southern Company, Dominion Energy, Duke Energy, Xcel Energy, AES Corp, Alliant Energy and Evergy. Our research trip also yielded insights into the US freight and railroad markets, with recovery expectations pushing into 2025 given an uncertain economic backdrop. You can read the full version of our US field notes here.

Sophie Smith is an Analyst, and Jessica Jouning a Portfolio Manager with the Global Listed Infrastructure team at First Sentier Investors, a sponsor of Firstlinks. This material contains general information only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs.

For more articles and papers from First Sentier Investors, please click here.

The ATO has SMSF asset valuations in its crosshairs

Julie Steed

The ATO recently wrote to the trustees of approximately 16,500 self-managed superannuation funds (SMSFs) which have reported unlisted assets at the same value for at least the last three financial years.

Unlisted assets identified as a concern by the ATO include residential and commercial property, unlisted companies and unlisted unit trusts. The ATO also wrote to approximately 1,000 auditors who have performed audits on the 16,500 SMSFs where no audit contraventions were reported in respect of the market valuation rules.

In this article we will review the asset valuations requirements for SMSFs.

Legislative requirements

Superannuation law requires all assets to be valued at market value for the 2012/13 year of income, and all subsequent years [1].

Market value is defined as the amount that a willing buyer of the asset could reasonably be expected to pay to acquire the asset from a willing seller if the following assumptions were made:[2]

1. that the buyer and the seller dealt with each other at arm's length in relation to the sale;
2. that the sale occurred after proper marketing of the asset;
3. that the buyer and the seller acted knowledgeably and prudentially in relation to the sale.

ATO guidance

The trustee needs to have a reasonable basis for determining the market value of an asset. The ATO has published valuation guidelines for SMSFs which provides guidelines that are relevant for all funds when interpreting the market valuation definitions.

The ATO's valuation checklist provides that valuations based on objective and supportable data should be used when:

- preparing SMSF financial accounts and statements
- testing whether the market value of an SMSF's in-house assets exceeds 5% of the fund's total assets
- determining the value of assets that support a pension
- acquiring an asset from a related party
- disposing of an asset to a related party

A valuation conducted by a qualified independent valuer is required when collectables and personal use assets are transferred or sold to a related party.

The proposed Division 296 tax may also have focused the Government's attention on valuations since the value of a member's total super balance is the basis for how the proposed tax will be calculated.

Valuation principles require the trustee to be able to demonstrate that the valuation has been determined on a 'fair and reasonable' basis. A valuation is generally considered fair and reasonable where:

- it considers all relevant factors likely to affect the value of the asset
- it has been undertaken in good faith
- it uses a rational and reasoned process
- it can be explained to a third party

The acceptability of a valuation is more likely to depend upon the process of obtaining the valuation rather than the person who conducted the valuation. The valuation must be based on objective and supportable data.

Depending on the situation, a valuation may be undertaken by a:

- registered valuer
- professional valuation service provider
- member of a recognised professional valuation body
- person without formal valuation qualifications but who has specific experience or knowledge in a particular area.

The ATO valuation guidelines specifically state that trustees are not automatically required to arrange an external valuation for all assets each year. For example, assets such as real property may not need an annual valuation unless a significant event occurred that may change its market value since it was last valued. Unfortunately, in Australia recently, property prices have been erratic. In many instances, it would be difficult to be confident that the value of a property hadn't changed in the last three years.

In practice

I frequently hear trustees and advisers say that property assets only need to be valued every three years. This is simply not true, never has been and most certainly has not been for the last 12 years.

Trustees should consider the use of a qualified independent valuer if an asset represents a significant proportion of the fund's value or if the nature of the asset makes it likely that the valuation will be complex.

SMSF trustees need to demonstrate that a valuation has been determined using a fair and reasonable process that is based on objective and supportable data. This may involve research including market appraisals, council valuations and searches of similar property values. Trustees should retain all of the information used to determine the market value and present this to the SMSF auditor. Following a robust process can allow trustees to save the fund considerable expense whilst still meeting the legal requirements for valuing fund assets.

It is important to appreciate that auditors are not licenced valuers. The auditor's role is to examine the evidence that the trustee has provided to support the valuation and determine if that evidence is fair and reasonable, based on the objective and supportable data provided.

Penalties

The requirement to value assets at least annually is an operating standard which means it is a requirement that auditors review the evidence supporting the valuation.

If a trustee's valuation fails to meet the valuation requirements, the trustee is likely to be liable for administrative penalties. Serious failures could result in the SMSF losing its complying status.

Summary

SMSF trustees need to ensure that they value their assets at least annually and that their valuations are fair and reasonable and based on objective and supportable data. It is not adequate that trustees only apply the required level of effort to valuations if they expect the valuation to impact an important threshold such as a pension commencement, related party transactions or total super balances to determine eligibility to make certain contributions.

[1] *Superannuation Industry Supervision Regulations 1994* regulation 8.02B
[2] *Superannuation Industry Supervision Act 1993* section 10(1)

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Should investors follow super funds into private credit?

Peter Szekely

Investors are increasingly being attracted by the relatively high yields and stability of returns offered by private credit.

Australia's largest superannuation funds are leading the way by allocating billions of dollars into this asset class, and we expect robust growth over the next year. However, many retail investors and self-managed superannuation funds (SMSFs) are not yet allocating as much to private credit as larger institutions.

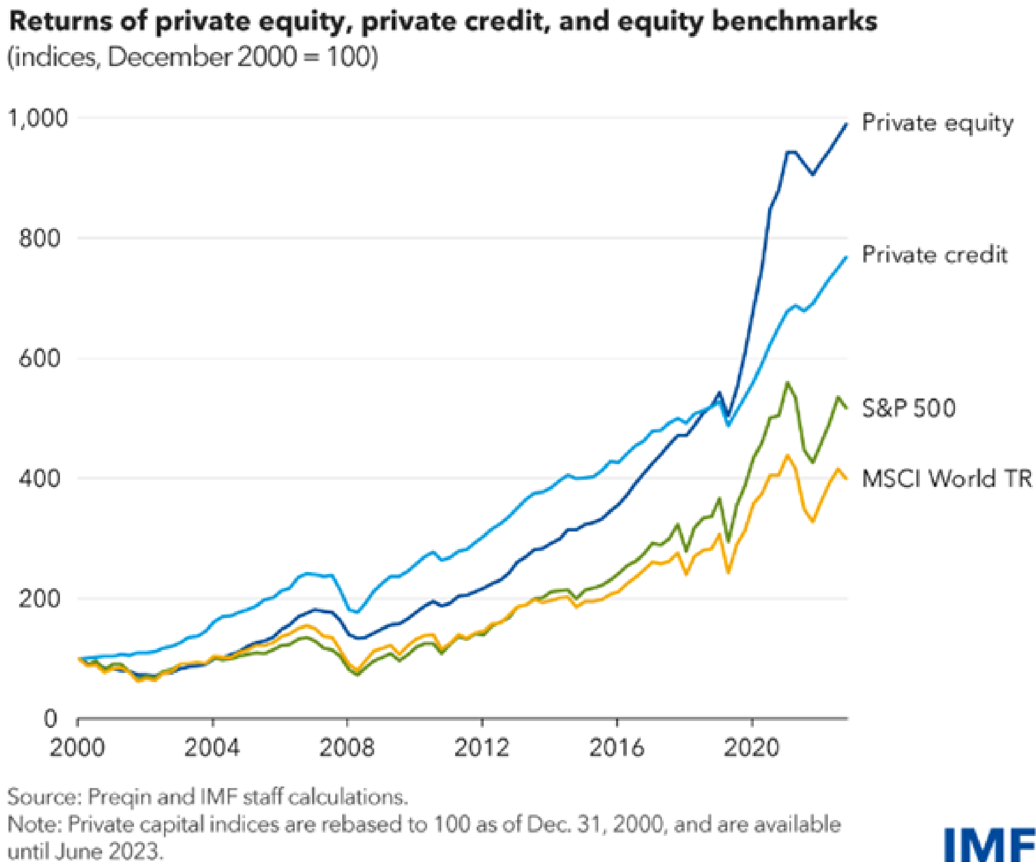
The growth of private credit is a global phenomenon and institutional investors in particular have recognised the benefits of relatively attractive yields with lower volatility than shares or publicly traded corporate bonds.

Assets under management for the global private debt market topped US$2.1 trillion (A$3.15 trillion) in 2023, and the asset class is projected to increase to US$2.3 trillion by 2027, according to research house Preqin.

Private credit investments, such as senior secured corporate loans, offer investors gross yields above 10%. This could represent an attractive opportunity for investors to benefit from regular income while their capital is protected by the loan's senior secured position at the top of the capital stack.

The International Monetary Fund (IMF) recently noted in this research paper the sharp growth of private credit asset allocations globally, with most demand coming from institutional investors such as superannuation funds. The chart below from the IMF displays the performance of private credit against other asset class benchmarks.

Figure 1: Outpacing other asset classes
Private credit has delivered high returns with what appears to be relatively low volatility.



In Australia, several larger industry superannuation funds such as Cbus and Aware Super are directly investing in private credit, while other funds are choosing to invest through specialist private credit fund managers to gain exposure to the asset class. AustralianSuper is one of the largest investors and has allocated over US$4.5 billion (A$7 billion) in private credit globally, with the stated ambition to triple its exposure in the coming years.

Cbus is reportedly planning to triple its global allocation to private credit over the next 18 months, while fellow industry fund Hostplus is also looking to add to its already record holdings of the asset class.

Separately, the biggest investment allocations UniSuper has made into any asset class over the past 18 months has been in the debt markets, not equity markets. While the fund is holding back on allocating any more to investment-grade bonds, believing them to be expensive, UniSuper's chief investment officer John Pearce recently told *The Wall Street Journal* that he is still taking bets on private credit.

Whilst once solely the domain of institutional investors, retail investors are benefitting from increased access to the private credit asset class. However, retail investors and SMSFs still haven't allocated much to private credit at all.

New data from the ATO reveals SMSFs have almost a $150 billion exposure to Australian property investments alone, with residential and non-residential property investments totalling a record $141.8 billion in the March 2024 quarter, up 6.2% from $133.5 billion in the December quarter. That represented 15% of total SMSF net assets, which sat at $932.9 billion on March 31, 2024.

SMSFs also invested a near record of $145.1 billion in cash and deposits, another 15% of their total assets, earning yields barely above inflation. Another $287.1 billion was invested in Australian and overseas shares, or around 31% of total SMSF assets.

In contrast, SMSFs have invested just $9.5 billion directly in debt securities and $6.5 billion in loans. Together these accounted for less than 2% of total SMSF assets.

Stable returns on offer

Given their high allocations to Australian property, shares and cash, SMSFs and retail investors overall could benefit from assessing greater allocations to private credit investments. Private credit investments could provide attractive all-cash returns of close to 10% for senior secured corporate debt, with much lower volatility in a more senior part of the capital structure.

The additional appeal to investors is that direct lending to companies typically provides investors with higher returns and greater influence over loan structure, terms and conditions compared to lending into large syndicated deals or publicly traded bonds.

With inflation remaining sticky, this could favour yields on private credit as interest rates on corporate loans are typically floating rate. This could allow investors to take advantage of interest rates in a higher for longer scenario. Gross cash yields of around 10% for private credit portfolios represent an attractive level of regular cash income for investors, particularly in comparison to the long-run average returns of other more volatile asset classes such as equities and commercial property.

Share market valuations are also relatively high versus historic long run averages and could correct over the next 12 months. In our opinion, private credit offers investors the potential for downside protection in this environment and diversification into an attractive, defensive asset class with features and characteristics that mitigate several investor concerns.

However, it is important to invest with an experienced fund manager to maximise the benefits offered by the asset class. A manager with a strong focus on deal selection will be key to success in 2024 and beyond as higher interest rates challenge some sectors of the economy.

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Learn from the last tech bubble and embrace GenAI mania

Que Nguyen

If the emerging boom in Generative AI (GenAI) is to follow the evolution of the internet, today’s enthusiasm and capital deployment could only be beginning.

In this sense, the release of ChatGPT in 2022 has been likened to the release of the Mosaic browser in 1993, which popularised access to the World Wide Web and released a torrent of investment and interest in the emerging technology.

As with GenAI today, the early days of the internet boom were characterised by recognition of the technology’s transformative potential but uncertainty around the specifics of the opportunity set.

Ultimately, the internet boom featured three main categories of company:

1. **Backbone companies** that were ‘picks and shovels’ plays on internet infrastructure. Members of this group included telecom, cable and networking hardware companies.
2. **Gateway companies** that provided the hardware and software needed for people to access the internet. Notable members of this group included the PC manufacturers and the “Wintel alliance” of Microsoft Windows software and Intel chips installed in most of the devices.

3. **Destination companies** – the dot-com internet businesses that aimed to give internet users things to do and buy on the World Wide Web. Notable members of this group included eBay, Amazon and several doomed ventures like WebVan and Pets.com.

Today, businesses are just beginning to build out the infrastructure to deploy GenAI. As a result, today's most-talked-about GenAI stocks tend to be backbone-like investments. These include chip companies Nvidia and Micron, hardware company Super Micro Computer, and cloud services companies like Amazon and Microsoft Azure.

Today's GenAI gateways include OpenAI's ChatGPT, Microsoft's CoPilot, and Google's Gemini/Bard. Although recent progress in improving the accessibility of GenAI has been rapid, these tools have not yet reached the ease-of-use that Windows gave to PC users to spark ubiquitous adoption. Further improvements over the next few years should prove exciting.

More and bigger opportunities to come?

With this in mind, the GenAI investment cycle is likely to last years and there could be far bigger opportunities still to come.

Consider that three of the most dominant companies of the tech ecosystem *today* played little role in the internet boom of the 1990s. Alphabet did not go public until after the internet boom (2004). Meta wasn't founded until 2004 and went public in 2012. Apple existed during the bubble but was a dark horse.

Indeed, Apple has the most impressive and unlikely story. Not only was the company considered an also-ran to the main internet darlings, it nearly went bankrupt in the 1990s. At the bubble peak in 2000, Apple, Amazon, and eBay all had similar market caps. Today, Apple's market cap is 40% larger than Amazon's and 96x larger than eBay's.

Table 1: Relative Market Cap and Total Returns Over Time
Amazon, eBay, Apple, Hewlett Packard

	Market Capitalization ($Millions)			
	Amazon	eBay	Apple	Hewlett Packard
Dec-1996	438**	1,880**	2,559	51,095
Mar-2000	23,125	22,842	21,896	132,577
Sep-2002	6,061	14,883	5,204	35,611
Mar-2024	1,873,676	27,430	2,647,974	52,619*
	Returns (Annualized)			
1996-Q1 2024	33.6**	22.6**	29.2	6.6
Q1 2000-Q3 2002	-43.7	-18.5	-46.1	-44.1
Q1 2000 - Q1 2024	18.1	7.9	23.8	3.2

Source: Based on data from Research Affiliates and Bloomberg.
* Includes HP Enterprise, which was spun out in 2015.
** Amazon went public in May 1997 and eBay went public in Sep 1998. Returns are from end of first day of trading; market caps are from IPO valuation.

In various ways, the ultimate success of today's giants depended heavily on investments inspired by the internet boom.

While the tech bust destroyed billions of dollars in capital, the investments made during the boom in communications, chips, software, and hardware allowed companies to build newer and more innovative applications and businesses. Apple's iPhone, for example, would not have been possible without the investment in mobile communications infrastructure.

These investments and new products have also accrued to the benefit of society. The lower price of broadband makes high-speed internet and mobile communications affordable to a wider audience, enhancing productivity and convenience for all of us.

Lessons learned from the dot-com boom

1. Capital discipline is paramount—fundamentals ultimately matter

The worst failures of the internet boom were the companies that could not finance their own growth and had no tangible plans to earn a return on capital. Not all financially strong companies had an easy time in the bust. But these companies at least survived and delivered some value to their shareholders over time. Capital discipline is necessary not just for corporations but also for investors. Those who invested in profitable, well-capitalized tech companies in 1996 fared well over the long term. Those who piled into speculative companies at the height of the mania while eschewing "old economy" stocks often experienced significant losses.

2. Picking winners (and losers) is hard—better to own a diversified portfolio.

With hindsight, picking winners looks easy. But even once seemingly invincible companies, such as Intel, can falter, and some of the biggest winners of the internet revolution only emerged later. Likewise, picking losers is difficult, as technology and its use evolve in unexpected ways. For example, while some prognosticators predicted the end of using office paper, the spread of personal computing and printing peripherals actually increased paper use for many years. The evolution of GenAI will also be unpredictable, and it is likely that some of the greatest GenAI companies have yet to emerge.

3. Technological progress benefits us ALL—stay invested and diversify

The excesses that culminated in the dot-com bust were extremely painful and capital destructive. Despite the massive misallocation of much capital, some of that capital built useful networks, software, and databases, creating a framework to launch great businesses and increase productivity. While dot-com companies were once seen as niche businesses, every company now has a website. Households enjoy the convenience of online shopping from a myriad of businesses. Zoom would not have been possible without prior broadband investment.

Reflecting these broad qualitative benefits to society, investors that showed discipline also gained.

The table below shows the 25-year performance of the S&P 500 index, the more tech-heavy Nasdaq 100 and the RAFI™ US Fundamental Index, which owns almost all the companies in the S&P 500 and Nasdaq 100 but weights stocks by fundamentals rather than mania-induced prices.

Table 2: Performance of US Equity Indexes Over the Past Quarter Century

	Annualized Total Returns		
	S&P 500	Nasdaq 100	RAFI US
1996-Q1 2024	9.4	12.8	10.8
Q1 2000-Q3 2002	-20.5	-48.6	-4.8
Q1 2000 - Q1 2024	7.4	6.9	9.9

Source: Based on data from Research Affiliates and Bloomberg.

As the price mania in internet companies unfolded, the S&P 500 became more exposed to tech stocks in early 2000 and the Nasdaq 100's increase in exposure to internet themes was even greater. Nevertheless, an investor who allocated capital at the end of 1996 (early in the internet boom) would have achieved double-digit returns from both the RAFI strategy and the Nasdaq 100 over the next 27 years.

Had the same investor allocated at the peak of the bubble in March 2000, returns would have been lower but still fairly good. This is particularly true for RAFI US investors because that index did not get as over-allocated to tech in 2000.

The only investor to suffer significant capital loss was the one who piled in at the peak and sold out over the next 18 months. Even then, a RAFI US investor would have suffered a much smaller drawdown. In the long run, the productivity benefits of the internet boom have benefited businesses and investors beyond the tech sector.

A note of caution

As optimistic as we are about the potential of GenAI, we would not be acting responsibly if we failed to point out some challenges the new technology could face. The main challenges are carbon intensity, regulation and de-globalisation.

1. Large language models (LLMs) that read and process thousands of documents in seconds consume large amounts of energy. As use of these models spreads, the competition for energy resources could drive prices to a level that would make certain GenAI activities uneconomic. Additionally, as governments and companies increasingly commit to environmental goals, would society continue to allocate energy resources towards GenAI? Could GenAI continue to grow without cheap computing power, which increasingly means cheap energy?
2. New technologies always spawn some level of fear and distrust. While the internet emerged during a time of de-regulation, the tech bust and the Great Financial Crisis curtailed that ethos. Today, our society is more amenable to reigning in large tech and new tech. Already, copyright challenges are putting limits on the amount or types of information that GenAI models can use. Regulation could emerge in other areas as well, including privacy, safety, and discrimination. Can the cost of adaptation be overcome?
3. The internet emerged during a long period of globalization. The Berlin Wall had fallen, the number of former communist nations was increasing, and movement of goods as well as human capital flowed more freely. This global integration provided resources in capital and human capital to make rapid progress in technology and business ideas. With today's world possibly on a path of de-globalization, there could be a sustained trend of rising barriers to the movement of people, capital, and ideas. Will the necessary resources be available to make the rapid advancements that a GenAI boom would require?

While we do not believe these challenges to be insurmountable, investors should bear these risks in mind as GenAI evolves.

Concluding remarks

To be sure, not every mania creates something useful and enduring. Tulips and perhaps cryptocurrencies might be seen as less-than-useful manias. However, if GenAI is as revolutionary as we think it will be, a mania is likely to develop.

In the event of a GenAI bubble, capital will be misallocated and fortunes lost. On balance, though, the gains will be greater than the losses. Society and investors will ultimately benefit, and these benefits will be felt very broadly beyond the immediate GenAI companies.

If investors believe that GenAI will be as impactful as the internet, they will need to participate by getting invested, and the best approach will be to stay diversified and be prepared to hold through ups and downs.

Those who have a high threshold for risk may opt for a highly concentrated approach in current behemoths, such as the Nasdaq 100. Those who believe the benefits of AI will be shared broadly and that winners may change over time should opt for a fundamentally based approach with disciplined rebalancing, such as the RAFI Fundamental Index strategy.

Que Nguyen is a Partner, Chief Investment Officer, Equity Strategies lead, and a member of the Management Committee of Research Affiliates. Please read Research Affiliates' disclosures concurrent with this publication: https://www.researchaffiliates.com/legal/disclosures#investment-adviser-disclosure-and-disclaimers. This is an edited version of the original article, linked here.

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Firstlinks

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Most aged care homes are falling short of minimum care standards

Michael Woods, Nicole Sutton

New analysis has revealed many Australian aged care residents are not receiving the levels of care they need and are entitled to.

The UTS Ageing Research Collaborative, which we are involved in, recently released its 2023–24 mid-year report on Australia's aged care sector.

A particular focus of this edition was on the level of direct care being delivered in aged care homes by nurses and personal care workers to residents. In sharing this analysis, we acknowledge there is a well-documented shortage of workers across the economy, with the unemployment rate at a near-historical low. And even given these workforce pressures, many aged care providers are delivering very high levels of care.

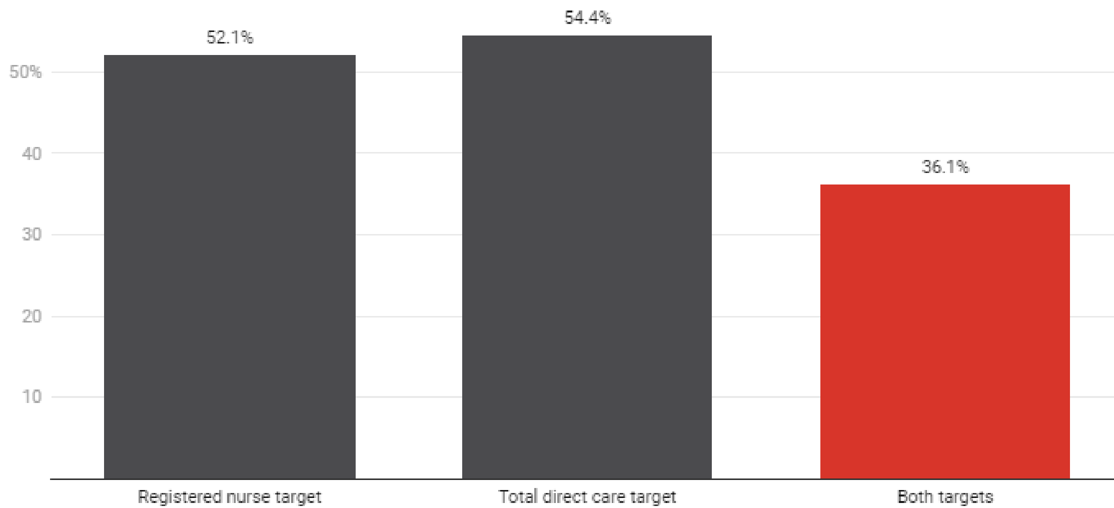
But a significant number are not. Nearly two-thirds of aged care homes are failing to meet mandated levels of direct care. And yet taxpayers have paid millions of dollars to providers to deliver that care. Some providers are making large surpluses as a result.

New standards for direct care

In response to the findings of the Royal Commission into Aged Care Quality and Safety, the federal government committed to setting minimum standards for the level of direct care time that residents were to receive. In 2022, all providers were given a year to raise their level of staffing to reach these standards and were funded to do so.

These standards require a sector-wide average of 200 minutes of direct care per person per day (from registered and enrolled nurses and personal care workers). And 40 minutes of this care has to be delivered by a registered nurse. The minimum level each resident should receive varies above or below that 200 minutes depending on their assessed needs.

These standards became mandatory on October 1 2023. For the first three months after the targets were mandated, only half of all providers met or exceeded either of their care targets (the total direct care minutes or the registered nurse target). Only 36% met both.



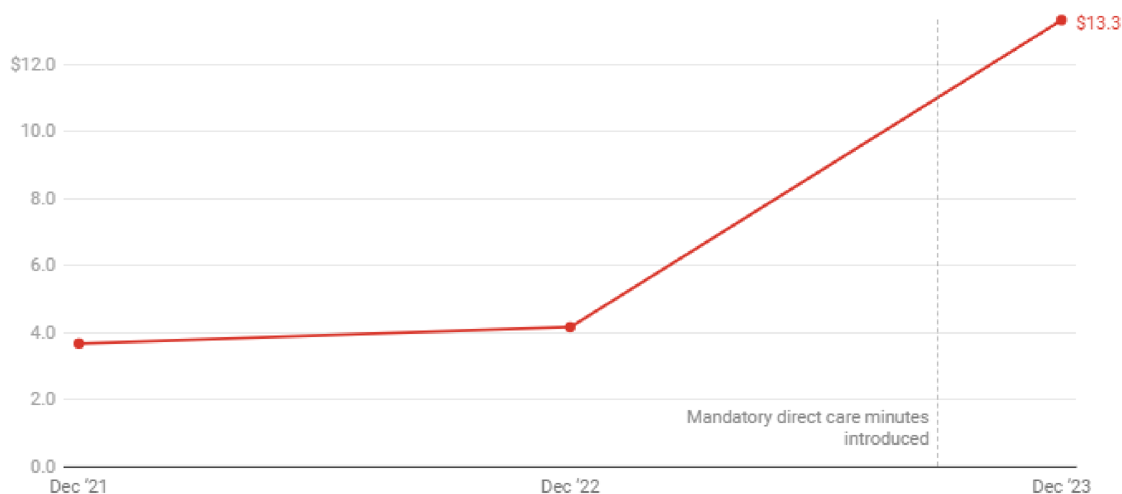
Funding the costs of care

Residential aged care is funded for three main activities:

- direct care such as nursing and personal care, including bathing, dressing, toileting and personal grooming (almost wholly funded by taxpayers)
- everyday living services such as food, laundry and cleaning (paid mainly by residents and capped at 85% of the single age pension)
- accommodation (paid by the government for those of limited means and self-funded by those with higher incomes and wealth).

On the advice of the Independent Health and Aged Care Pricing Authority, the government has increased the direct care funding for each resident living in an aged care home. The assumption is the home will spend that money to employ enough staff to meet its care level targets.

The report shows the difference between each aged care home's average funding for direct care and its expenditure on that activity. Comparing the mid-year results for the past three years, in 2021 and 2022 homes produced, on average, a small surplus where revenue was slightly greater than wages and other expenses. This situation, where funding is just above costs, is the intended result of the new pricing reforms.



But things have changed for the most recent period. The government has significantly increased funding to meet the costs of staffing to achieve the mandatory care levels. It has also increased funding in light of the pay rises to direct care staff, primarily nurses and personal care workers, which was decided by the Fair Work Commission.

This taxpayer funding has been provided to each home regardless of whether they are employing the required number of staff.

Because of the failure of some providers to meet their mandated targets to December 2023, the sector, on average, generated a significant direct care surplus of more than A$13 per resident per day. Some providers have been using the money to cross-subsidise losses they incur for their everyday living services and accommodation.

Which homes are not meeting their targets?

We found homes that were not delivering their mandatory care minutes were, on average, achieving significant financial benefits from their direct care activities. Homes that had staffing care levels well above their required number were making a loss from their direct care.

Further, the homes that were not delivering their mandatory care minutes were more often in metropolitan and larger regional centres. They were also more likely to be operated by for-profit providers.

In essence, while we acknowledge the tight labour market and the effort many homes are making to meet or exceed their mandatory requirements, a large number of residents are not receiving the care they need. This also means taxpayers are funding direct care that is not being delivered.

With the minimum sector average level of direct care due to rise to 215 minutes per resident per day on October 1 this year (and registered nurse care to rise to 44 minutes), this situation may get even worse.

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